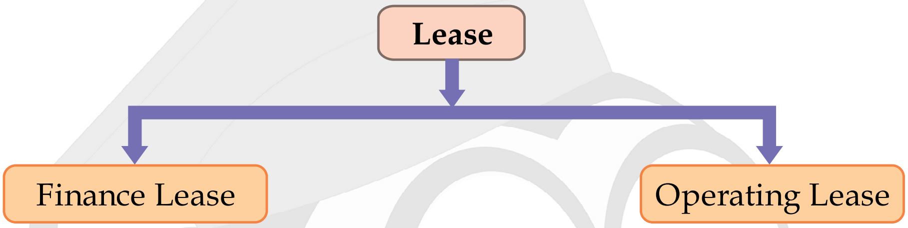
## 3. Lease Financing

*Lease financing is one of the important sources of medium- and long-term financing where the owner of an asset gives another person, the right to use that asset against periodical payments. The owner of the asset is known as lessor and the user is called lessee.*

The periodical payment made by the lessee to the lessor is known as **lease rental**. Under lease financing, lessee is given the right to use the asset but the ownership lies with the lessor and at the end of the lease contract, the asset is returned to the lessor or an option is given to the lessee either to purchase the asset or to renew the lease agreement.

**Different Types of Lease :** Depending upon the transfer of risk and rewards to the lessee, the period of lease and the number of parties to the transaction, lease financing can be classified into two categories.




**(i) Finance Lease :** *It is the lease where the lessor transfers substantially all the risks and rewards of ownership of assets to the lessee for lease rentals*. In other words, it puts the lessee in the same condition as he/she would have been if he/she had purchased the asset. *Finance lease has two phases: The first one is called primary period. This is non-cancellable period and in this period, the lessor recovers his total investment through lease rental. The primary period may last for indefinite period of time. The lease rental for the secondary period is much smaller than that of primary period.*

***Features of Finance Lease***

1. *A finance lease is a device that gives the lessee a right to use an asset.*
2. *The lease rental charged by the lessor during the primary period of lease is sufficient to recover his/her investment.*
3. *The lease rental for the secondary period is much smaller. This is often known as peppercorn rental.*
4. *Lessee is responsible for the maintenance of asset.*
5. *No asset-based risk and rewards is taken by lessor.*
6. *Such type of lease is non-cancellable; the lessor's investment is assured.*

**(ii) Operating Lease :** *Lease other than finance lease is called operating lease. Here risks and rewards incidental to the ownership of asset are not transferred by the lessor to the lessee.* The term of such lease is much less than the economic life of the asset and thus the total investment of the lessor is not recovered through lease rental during the primary period of lease. In case of operating lease, the lessor usually provides advice to the lessee for repair, maintenance and technical knowhow of the leased asset and that is why **this type of lease is also known as service lease.**

*Features of Operating Lease : Operating lease has following features :*

1. *The lease term is much lower than the economic life of the asset.*
2. *The lessee has the right to terminate the lease by giving a short notice and no penalty is charged for that.*
3. *The lessor provides the technical knowhow of the leased asset to the lessee.*
4. *Risks and rewards incidental to the ownership of asset are borne by the lessor.*
5. *Lessor has to depend on leasing of an asset to different lessee for recovery of his/her investment.*

**Advantages and Disadvantages of Lease Financing**

At present leasing activity shows an increasing trend. Leasing appears to be a cost-effective alternative for using an asset. However, it has certain advantages as well as disadvantages.

**Table :** Lease Advantages

| To Lessor | To Lessee |
|---|---|
| **Assured Regular Income :** Lessor gets lease rental by leasing and asset during the period of lease which is an assured and regular income. | **Use of Capital Goods :** A business will not have to spend a lot of money for acquiring an asset but it can use an asset by paying small monthly or yearly rentals. |
| **Preservation of Ownership :** In case of finance lease, the lessor transfers all the risk and rewards incidental to ownership to the lessee without the transfer of ownership of asset hence the ownership lies with the lessor. | **Tax Benefits :** A company is able to enjoy the tax advantage on lease payments as lease payments can be deducted as a business expense. |
| **Benefit of Tax :** As ownership lies with the lessor, tax benefit is enjoyed by the lessor by way of depreciation in respect of leased asset. | **Cheaper :** Leasing is a source of financing which is cheaper than almost all other sources of financing. |
| **High Profitability :** The business of leasing is highly profitable since the rate of return based on lease rental, is much higher than the interest payable on financing the asset. | **Technical Assistance :** Lessee gets some sort of technical support from the lessor in respect of leased asset. |
| **High Potentiality of Growth :** The demand for leasing is steadily increasing because it is one of the cost efficient forms of financing. Economic growth can be maintained even during the period of depression. Thus, the growth potentiality of leasing is much higher as compared to other forms of business. | **Inflation Friendly :** Leasing is inflation friendly, the lessee has to pay fixed amount of rentals each year even if the cost of the asset goes up. |
| **Recovery of Investment :** In case of finance lease, the lessor can recover the total investment through lease rentals. | **Ownership :** After the expiry of primary period, lessor offers the lessee to purchase the assets- by paying a very small sum of money. |

**Table :** Lease Disadvantages

| To Lessor | To Lessee |
|---|---|
| **Unprofitable in Case of Inflation :** Lessor gets fixed amount of lease rental every year and they cannot increase this even if the cost of asset goes up. | **Compulsion :** Finance lease is non-cancellable and even if a company does not want to use the asset, lessee is required to pay the lease rentals. |
| **Sales Tax may be charged Twice :** First at the time of purchase of asset and second at the time of leasing the asset. | **Ownership :** The lessee will not become the owner of the asset at the end of lease agreement unless he decides to purchase it. |
| **Greater Chance of Damage of Asset :** As ownership is not transferred, the lessee uses the asset carelessly and there is a great chance that asset cannot be usable after the expiry of primary period of lease. | **Costly :** Lease financing is more costly than other sources of financing because lessee has to pay lease rental as well as expenses incidental to the ownership of the asset. |
| | **Understatement of Asset :** As lessee is not the owner of the asset, such an asset cannot be shown in the balance sheet which leads to understatement of lessee's asset. |

**Sale and Leaseback**

*A leaseback is an agreement where an asset's seller leases back the asset from the purchaser.* In a leaseback arrangement, the details of the arrangement, such as the lease payments and lease duration, are made immediately after the sale of the asset. Essentially, the seller of the asset becomes the lessee and the purchaser becomes the lessor.

Most often, a company needs capital to grow. Companies acquire capital by either debt or equity financing or both. Debt must be paid back and goes on the company balance sheet as a debt. Equity does not need to be paid back, but it comes at the cost of ownership. A leaseback allows this to happen.

**Types of Leaseback**

*The most common users of sale-leaseback arrangements are builders or companies with high-cost fixed assets.* A leaseback arrangement is useful when a company needs to use the cash invested in an asset for other investments, but the asset is still needed in order to operate.

Leaseback deals can also provide the seller with additional tax deductions. The lessor benefits in that it receives a guaranteed lease with stable payments for a specified period of time.

Equity does not need to be paid back, but it comes at the cost of ownership

Although sale-leasebacks have a different accounting treatment than debt, they are generally not considered to be financing and therefore stay off the balance sheet. This is why some analysts add capitalized leases to long-term debt when trying to get a big picture of the company's total debt obligation.

- *A leaseback can be a good way to use your tools or products, but with a lower capital commitment.*
- *Leasebacks are most often found in businesses with high-cost fixed assets they can't easily offload.*